

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

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IN THE MATTER OF the Application of) REGULATORY DIVISION
Mountain Water Company for Authority to)
Increase Rates and Charges for Water) DOCKET NO. D2012.7.81
Service to Its Missoula, Montana Customers)

FACT SHEET

TO: Commissioners, Justin Kraske
FROM: Leroy Beeby and Kate Whitney
DATE: July 8, 2013

Prior to a public hearing on a rate case before the Public Service Commission (Commission), Regulatory Division staff on the work team prepare a Fact Sheet that summarizes the application and the prefiled testimony. The hearing in this docket is scheduled to begin Wednesday, July 10, 2013, in Missoula.

Procedural History

Mountain Water Co. (Mountain) filed its rate increase application on July 30, 2012. Montana Consumer Counsel (MCC) and the City of Missoula intervened in the case. The application included the prefiled direct testimony of Leigh Jordan, Edward N. Jackson, and John A. Kappes. MCC submitted the prefiled direct testimony of Dr. John W. Wilson and Paul R. Schulz on January 15, 2013. Mountain submitted the prefiled rebuttal testimony of Jordan, Jackson, Kappes, and Dr. Thomas M. Zepp on February 25, 2013. Following Mountain's filing of extensive rebuttal testimony on return on equity (ROE) issues, MCC filed a Motion to Strike or, in the alternative, requested the Commission to schedule further discovery and testimony from the parties. The Commission decided not to strike Mountain's rebuttal testimony but did set deadlines for additional discovery and testimony pertaining to ROE issues from the intervenors and Mountain. On June 7, 2013, MCC submitted the prefiled testimony of Wilson in response to Mountain's rebuttal testimony. Mountain submitted its second round of prefiled rebuttal testimony from Zepp and Jordan on July 3, 2013.

Mountain initially requested interim rate relief in the amount of \$575,036. On February 22, 2013, Mountain filed a Motion for Interim Rate Relief in the amount of \$277,377. On March 13, 2013, the Commission issued Interim Order No. 7251b, which granted the requested relief.

Application

In its application, Mountain requested to increase its rates for water service in Missoula by \$919,105, equal to an overall rate increase of 5.09%. According to Mountain, its annual revenue requirement for test year 2011 was calculated to be \$18,973,697, compared with annual revenues at current rates of \$18,054,592. The reason for the rate increase request cited by Mountain is to allow the utility to recover its expenses and taxes and to earn a proposed 9.29% return on rate base. Mountain proposed the following specific rate changes:

- A 5.8% increase to all flat rates, except Flat Rate Sprinkling Water service, which will increase the minimum monthly bill for a single-family home from \$50.08 per month to a proposed rate of \$53.01 per month. Mountain has 4,248 flat rate service customers.
- A 5.7% increase in the metered service rate, which will increase the monthly bill for a 5/8 x 3/4-inch meter with 15 Ccf usage from \$45.95 to \$48.56. Mountain has 17,519 metered service customers.
- A 15.5% decrease in Public Fire Protection fees, which will decrease the monthly charge for a customer with a 5/8 x 3/4-inch meter from \$1.64 to \$1.40.
- A 5% increase in the Private Fire Protection Service rate, which will increase the monthly bill for a 6-inch sprinkler line from \$49.21 to \$51.71. Mountain has 507 customers taking service under this tariff.
- A 5% increase in the Flat Rate Sprinkling Water rate, which will increase the annual bill for 5,000 square feet from \$195.13 to \$206.90.

Leigh Jordan Prefiled Direct Testimony

Leigh Jordan is the executive vice president of Mountain and of Park Water Co. (Park), the parent company of Mountain. He presented financial data and exhibits in support of Mountain's proposed revenue requirement.

According to Jordan, Mountain's capital structure consists of 56.12% equity and 43.88% debt. Mountain proposes an ROE of 10% and a rate of return of 9.29%. He said the proposed rate of return is based on the rate of return approved in Mountain's last rate case, in which the Commission approved a rate of return that included a 10% ROE and the actual capital structure

and debt cost. Jordan testified that Mountain earned a 7.74% rate of return during the 2011 test year on a rate base of \$36,325,650.

Jordan explained that Park provides financial and general administrative support for its subsidiaries, including Mountain. Park serves as the *de facto* borrower for its subsidiaries and provides them with a source of capital through inter-company transactions. Jordan said the capital structure about which he testified is based on the total Park consolidated capital structure and reflects Park's long-term debt, common stock, and retained earnings. He said this is a methodology that has been accepted and used by the Commission since 1994.

Edward N. Jackson Prefiled Direct Testimony

Jackson is Park's director of revenue requirements. He sponsored financial exhibits and provided testimony regarding Mountain's statement on interdepartmental transactions, income taxes, and depreciation and amortization expense. In his testimony regarding interdepartmental transactions, he described the four-factor allocation calculation, which Park uses to allocate main office expenses, rate base, investment tax credit, and deferred income taxes to its subsidiaries. He used the four-factor allocation method to calculate Mountain's share of those items.

John A. Kappes Prefiled Direct Testimony

John Kappes, president of Mountain, generally described Mountain's operations, explained the reasons for the proposed rate increase, and sponsored exhibits in support of the application. According to Kappes, Mountain's existing rates, based on its cost to provide service in 2009, do not reflect the utility's current cost of service. Kappes said Mountain's infrastructure upgrade efforts have increased 2011 end-of-test-year plant to \$90.4 million compared to \$84.5 million at the end of 2009. He testified that Mountain has increased its investment in water main replacements since 2009 at a total cost of \$2.47 million. Mountain also installed two new PRV stations on its system and added current Supervisory Control and Data Acquisition (SCADA) technology throughout its system. Kappes said Mountain added three new portable generators and installed 669 new meters in the test period.

Other areas covered by Kappes included: plant and accumulated depreciation, working cash, operation and maintenance (O&M) expenses, pro forma adjustments, revenues and other taxes. Kappes described the calculation of Mountain's cost of service and the proposed allocation of the cost of service to the various rate classes. He also explained the exhibits concerning the derivation of the proposed new rates and of the low-income discount.

John W. Wilson Prefiled Intervenor Testimony

Dr. John Wilson testified on behalf of MCC regarding Mountain's cost of equity and overall rate of return. He said that, according to his analysis of constant growth discounted cash flow (DCF) models, the ROE range is from 6.6% to 9.5%. His fundamental DCF estimate of ROE is 6.9% and the capital asset pricing model (CAPM) produced results centering around 6.4%. Overall, Wilson testified that his analyses indicated that a reasonable ROE would be in the range of 6.5% to 9.5%. Wilson recommended a specific ROE of 8.75% because money costs are very low right now and it is the same ROE recommended by the California Public Utilities Commission (PUC) staff in Park's recent rate of return proceeding. He noted that Park had sought an ROE of 11.95% in that case and ultimately settled for a 9.79% ROE.

Wilson testified that, if the allocated capital structure proposed by Mountain is accepted, as well as the debt cost, then his recommended ROE of 8.75% would result in a return on rate base of 8.59%.

Wilson suggested the Commission might want to address Mountain's debt costs in this case. He said Mountain's debt cost of 8.39% would be about 7.9% if Park had not refinanced a large portion of its debt in 2008. He acknowledged that the Commission had found the debt refinancing to be prudent in the 2010 rate case, but he suggested that finding does not foreclose the possibility of reducing the debt costs now or in the future if Park or its parent, Carlyle, are able to arrange more favorable financing.

Paul R. Schulz Prefiled Intervenor Testimony

Schulz, an MCC rate analyst, testified that his analysis and suggested adjustments to Mountain's financial exhibits result in a revenue requirement of \$18,270,852, which he later revised to \$18,238,816. (*See* MCC response to DR MWC-003(d), which includes Schulz' Revised 1st February 2013 direct testimony.) He proposed downward adjustments to the following items included in Mountain's filing that Schulz said were outside the 12-month post-test-year adjustment period: Mountain's health insurance expense (reduction of \$7,497 after allocation), Source Water Delineation and Assessment Report (SWDAR) expense (reduction of \$14,080), and utility plant acquisition amortization expense (reduction of \$10,104). Schulz also proposed downward adjustments to the following expense items reported by Mountain: travel for the hearing on the sale of Park to Carlyle (\$2,320), advertising/donations (\$2,503), main office

meals (\$615), main office general bonuses (\$13,551), consulting fees for Henry Wheeler (\$7,602), facility painting (\$19,872), and inventory adjustment for meter copperhorns (\$32,745).

Schulz suggested that the Commission may want to investigate whether Mountain is storing too much diesel fuel for use in emergencies, which results in ratepayers paying for a return on the diesel fuel inventory.

Schulz also proposed adjustments to Mountain's calculation of working cash.

Thomas M. Zepp Prefiled Rebuttal Testimony

Dr. Thomas Zepp, an economist, testified on behalf of Mountain that Wilson did not consider Mountain's company-specific risks in his ROE analyses. According to Zepp, Mountain requires a risk premium of at least 80 basis points because of its small size compared to the other water utilities in the benchmark sample and because Park is more highly leveraged now than it was when the California PUC determined Park required a risk premium.

According to Zepp, his re-evaluation of Wilson's analyses showed that the DCF approach supports an ROE for Mountain of 10.8% to 12.3%, the CAPM ROE range is from 10.3% to 12%, and the average of CAPM and DCF costs of equity indicates a range of 11.2% to 11.5%. Zepp concluded that Mountain's requested ROE of 10% is conservative and reasonable.

Leigh Jordan Prefiled Rebuttal Testimony

Regarding MCC witness Wilson's suggestion that the Commission may want to raise the issue of Mountain's debt costs in this case, Jordan argued it was unreasonable because the issue of Park's 2008 debt refinancing was addressed and resolved in Docket D2010.4.41 and Park's debt costs cannot be reduced by refinancing because the prepayment penalties are greater than the debt cost savings.

Jordan took issue with Wilson's testimony about the California PUC's rate of return proceeding. He said the 8.75% ROE for Park that was initially recommended by the California PUC staff was subsequently increased to 9.79% when PUC staff entered into a settlement with Park. He also noted that PUC staff's analysis produced a 9% ROE result initially, but it was reduced by 25 basis points because Park has a decoupling mechanism in place. Mountain does not have such a mechanism. Jordan argued that it is not reasonable to use the ROE resulting from the California PUC proceeding as a basis for Mountain's ROE because there are differences in risk between Park and Mountain and the ROE settlement in California was part of a package

cost of capital settlement that also included a capital structure with 57% equity and the acceptance of Park's projected debt cost estimates.

In support of Mountain's position that Park and Mountain are riskier than the average of the companies in Wilson's benchmark sample, Jordan summarized his testimony before the California PUC where he has advocated for an ROE premium. He said Park's risk cannot be measured in the market because its stock is not publicly traded; however, he said Park's higher level of risk can be demonstrated by: (1) evidence that its credit rating would be BBB; (2) Park's cost of debt; and (3) quantitative company-specific risk analysis and ROE premium. Jordan contended that Park's, and Mountain's, size contributes to its increased risk, as do its limited access to financing and its operational and financial riskiness.

Edward Jackson Prefiled Rebuttal Testimony

Edward Jackson testified that Mountain does not agree with the health insurance expense adjustment proposed by MCC witness Schulz because the amounts proposed by Mountain in its response to PSC-048 are known and measurable changes and within the 12-month post-test-year adjustment period.

Jackson also disagreed with MCC's proposed 3-year averaging methodology to adjust employee bonuses. He said Mountain has determined the effect of its proposed alternative to be a decrease of \$14,553.

John Kappes Prefiled Rebuttal Testimony

Kappes objected to Schulz's proposed adjustment to health insurance expense. He argued that the health insurance expense included in Mountain's filing was appropriate under Commission rule as a known and measurable change during the 12 months following the test year. According to Kappes, Mountain's employees had the 2013 premiums withheld from their pay during the pay period December 17-30, 2012, at which point the higher level of health insurance expense was in effect.

Kappes also disagreed with Schulz' proposed disallowance of Mountain's expense for the SWDAR study. According to Kappes, the expense is an allowable known and measurable change within 12 months following the test year because Mountain contracted for the study on November 30, 2012, work started in December 2012, and the first invoice was recorded in Mountain's books on December 31, 2012. Kappes disputed Schulz' argument that because Mountain voluntarily withdrew an expense for the Asset Aging Study that will not be conducted

in 2012, similar treatment should be accorded to the SWDAR study that will also not be conducted in 2012. Kappes said Mountain withdrew the Asset Aging Study expense not because of timing, but because there was no known and measurable change at all in 2012 related to that study due to Mountain's decision to do a preliminary in-house analysis rather than hire an outside contractor.

According to Kappes, Mountain agrees with MCC's removal of \$700 in expenses for donations to the Cystic Fibrosis Foundation and the Multiple Sclerosis Foundation, but disagrees with removing the expenses related to the Montana Section of the American Water Works Association and Mountain's participation in the Missoula County Fair. Kappes contended those activities provide important educational opportunities and were mischaracterized by Schulz as advertising/goodwill.

Kappes said he opposed MCC's proposed methodology to use a three-year average for Mountain's painting expense. He argued that, except for the averaging method used to adjust revenues for weather normalization, Mountain has complied with the Commission's rules with this filing and there is no reason to "smooth out the variability" for selected accounts as MCC has recommended. He said Mountain's filing estimated painting expense at \$67,900 and the known and measurable expense through 2012 is \$28,167, resulting in a reduction of \$39,733 from the as-filed expense.

Kappes took issue with MCC's expense adjustment for copperhorns. He proposed as an alternative to the elimination of the O&M expense adjustment that Mountain retain the original increase to expense in the T&D Meter Maintenance account of \$32,745, and also reduce utility plant by \$16,373, which results in a reduction in the overall revenue requirement of \$2,103.

John W. Wilson Prefiled Rebuttal Testimony

Wilson disputed the testimony of Mountain's witnesses Jordan and Zepp regarding Mountain's small size presenting greater risk, their rebuttal of Wilson's recommendation to reduce Mountain's ROE from the stipulated level of 10% that was approved by the Commission in 2011 to 8.75%, and Zepp's criticism of Wilson's analysis in support of a reduced ROE.

According to Wilson, two major changes have occurred since the Commission approved Mountain's current 10% ROE in March 2011: (1) money costs have significantly declined since 2011, as evidenced by expected common equity returns and significantly lower rates on 30-year

and 10-year Treasury bonds; and (2) Mountain and Park are now owned by the Carlyle Group, which should have lower money costs and much greater access to capital than the companies' previous owners. Wilson said there is no justification for continuing Mountain's 10% ROE given the significant decline in money costs. He said his recommended ROE of 8.75% is supported by his analysis and is consistent with today's market.

Regarding Carlyle's acquisition of Mountain and Park, Wilson recalled that Carlyle witnesses in that case touted the long-term benefits to customers, including improved access to capital markets and other funding sources, while Mountain's witnesses in this docket portray Park and Mountain as small stand-alone utilities that are riskier than larger water utilities. Wilson contended that Mountain's witnesses ignore the fact that Carlyle, a company with over \$40 billion in its own assets, is now Park's and Mountain's owner and is a much larger company than any of the comparable utilities.

Wilson disagreed with Jordan's argument that it was inappropriate for Wilson to raise the issue of Mountain's high debt cost in this case because this issue was resolved in Docket D2010.4.41 and that neither Park nor Mountain had indicated in the Carlyle acquisition docket that Carlyle as the new owner would be able to refinance existing debt at a lower rate. Wilson pointed to testimony from a Carlyle witness in the acquisition docket that indicated Carlyle would try to buy down Park's debt if it was the utilities' owner.

Wilson also disputed Zepp's criticisms of his cost of capital analysis and called the adjustments made by Zepp to his calculations unwarranted.

Thomas M. Zepp Prefiled Sur-Rebuttal Testimony

Zepp asserted that, if he had filed direct testimony in this case rather than rebuttal testimony responding to Wilson's original testimony, he would likely have arrived at an ROE range of 10% to 11.5% based on the benchmark sample of water utilities.

Zepp disagreed with Wilson's testimony that, because Park and Mountain are now owned by Carlyle, there is no basis for an equity risk premium. According to Zepp, equity cost is an opportunity cost that is available in the market and, therefore, does not depend on the type of owner. Zepp said Wilson erred when he stated that required profit rates have decreased since 2011. Zepp cited two recent studies that found the equity risk premium is currently at a very high level. (See Exh._TZ-2 for a May 2013 analysis.) Zepp contended that the documents

presented by Wilson in Exh._JW-8 are not relevant to the California PUC's ROE determination for Park, but actually may explain that the California PUC reduced Park's ROE because Park has a decoupling mechanism in place.

According to Zepp, Wilson's DCF methodology should be rejected because it is designed to produce a downward bias in equity cost estimates, is not used by Wilson in other jurisdictions, and is inconsistent with the present value formula Wilson used in his direct testimony. Zepp defended the growth rates he presented in his DCF analysis and argued that whether he had used forecasts from Value Line or from Reuters, either approach would result in a DCF estimate higher than 8.75%. Zepp said Wilson's exclusion of "sv" growth from his analysis biased downward his DCF estimates.

Regarding Wilson's CAPM comments, Zepp contended that Wilson presented a limited discussion of risk-free rate definitions, that Wilson's application of the CAPM using short-term Treasury bills appears to be designed to bias downward ROE estimates for utilities, and that a zero-beta CAPM (known as the Empirical CAPM) does exist and has for many years.

Leigh Jordan Prefiled Sur-Rebuttal Testimony

Jordan disputed Wilson's testimony that Carlyle's witnesses in the acquisition docket promised improved "capital attraction benefits" as a result of Carlyle's acquisition of Park. Jordan said that witnesses in that docket asserted the acquisition would improve the utility's access to capital, but did not assert it would result in attracting capital at lower rates as Wilson now contends.

Regarding Wilson's assertions that Mountain's witnesses are portraying Park and Mountain as small, more risky utilities when the utilities are now owned by Carlyle and should be considered less risky, Jordan said that neither Carlyle and Mountain nor any other entity testified in the acquisition docket that the acquisition would reduce Mountain's or Park's risk or cost of capital. He argued that Mountain's witnesses did not address these issues in their rebuttal testimony because they were responding to Wilson's direct testimony, in which, Jordan said, Wilson barely mentioned Carlyle, the acquisition, or the refinancing of Park's debt. He added that Mountain does not agree that the acquisition of Park by Carlyle means that the utilities should now be viewed as parts of a very large firm with less risk and lower capital costs. According to Jordan, the California PUC Division of Ratepayer Advocates assessed Park's risk

in a 2012 docket in that state on the basis of Park's operations and financial performance, not on its parent.

Regarding Wilson's claim that a Carlyle witness in the acquisition docket represented that Park's debt could be refinanced at favorable terms if Carlyle acquired Park, Jordan said Wilson mischaracterized that witness' testimony. According to Jordan, the witness in question testified that the debt was Park's private placement debt with a make-whole requirement, which would make refinancing challenging and which would not necessarily produce ratepayer savings.

In response to Wilson's testimony concerning regulatory risk and the California PUC settlement for a 9.79% ROE, Jordan reiterated that his ROE recommendation was not based solely on the difference in regulatory risk between California and Montana. Further, he said, the articles that comprise Wilson's Exhibit_JW-8 mainly concern California's business climate, not its regulatory climate, and do not address Montana's regulatory climate. Jordan listed several differences between utility regulation in Montana and California before opining that there is more regulatory risk in Montana because the regulatory framework in Montana makes it more difficult for a utility to earn its authorized ROE. Jordan included as Exhibit_LJ-3 a 2005 NARUC resolution on best regulatory practices wherein some recommended mechanisms, such as use of a future test year, authorization of distribution system infrastructure charges and inclusion of construction work in progress in rate base, are available in California but not in Montana. He also cited the January 2013 assessments of state regulatory climates by R.W. Baird, an investment bank, which found California's regulatory climate to be "generally constructive" while Montana was characterized as "marginal."

According to Jordan, his testimony recommending at least a 10% ROE for Mountain is not inconsistent with the 9.79% ROE that Park settled on in the California PUC proceeding.